Will Firming Fundamentals Lead to a Firmer Fed?

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by Team

of Northern Trust

Real gross domestic product (GDP) of the U.S. economy declined at an annual rate of 2.9% in the first quarter. Bad weather and distortions from the Affordable Care Act (ACA) left overall growth significantly weaker than expected. Nominal GDP fell at an annual rate of 1.7% in the first quarter, the first such occurrence during an expansion in the entire post-war period.

More recent readings, including last week's employment report, reflect a much stronger picture. And so while we have revised our full year 2014 projection for growth to account for the slow start, we remain confident of underlying momentum. Our expectations for the path of monetary policy have not changed, but discussions of potential restraint may intensify in the months ahead.

Key Economic Indicators

	2014				2015				Q4 to Q4 change			Annual change		
	14:1a	14:2f	14:3f	14:4f	15:1f	15:2f	15:3f	15:4f	2013a	2014f	2015f	2013a	2014f	2015f
Real Gross Domestic Product (% change, SAAR)	-2.9	3.1	3.0	3.2	3.4	3.1	3.3	3.3	2.6	1.6	3.3	1.9	1.5	3.2
Consumer Price Index (% change, year-over-year)	1.8	2.9	1.7	1.8	1.8	1.8	2.0	2.1	1.2	2.1	1.9	1.5	1.9	1.9
Civilian Unemployment Rate (%, average)	6.7	6.2	6.1	6.0	5.9	5.8	5.7	5.6				7.4*	6.4*	6.0*
Federal Funds rate	0.07	0.09	0.10	0.10	0.10	0.10	0.10	0.50				0.11*	0.09*	0.20*
2-yr. Treasury Note	0.37	0.42	0.50	0.63	0.77	0.93	1.15	1.51				0.31*	0.48*	1.09*
10-yr. Treasury Note	2.76	2.62	2.85	3.05	3.25	3.50	3.70	3.80				2.35*	2.82*	3.56*

a=actual
f=forecast
*=annual average

Key elements of the forecast:

- Consumer spending slowed significantly in the first quarter, to a 1.0% gain after a 3.3% increase in the fourth quarter. The large revision of health care expenditures and poor weather explain this weakness. Available information about health care expenditures for April and May and a conservative assumption for June suggest a modest decline of this component in the second quarter. Exceptionally strong auto sales in both April and May should more than offset this setback. On net, consumer spending is predicted to have risen at a moderate pace in the second quarter.

- Residential investment expenditures dipped in the first quarter, partly due to harsh weather. Residential construction outlays for April and May suggest a modest reversal in the second quarter. A pickup in sales of new and existing homes during April and May is noteworthy. The nature of recent employment data is supportive of a stronger showing of residential investment expenditures in the months ahead.

- Although the trade deficit is forecast to widen modestly in the second quarter, the petroleum trade balance continues to shrink. A reduction in petroleum imports results in a smaller drag on headline GDP from the trade component.

- Firms are hiring at a notable clip in the last few months. The latest six-month moving average of payroll employment at 230,000 is a distinct improvement from the 185,000 average seen at the end of 2013. The jobless rate of 6.1% in June has already matched the year-end 2014 forecast and is within reach of the Federal Reserve's forecast of the long-term unemployment rate.

- Despite the improvements in the labor market, lackluster wage gains are a drawback. As we noted in prior commentaries, strong growth in employment compensation is critical for the Fed to be convinced easy monetary policy conditions are no longer necessary.

- Bank lending in the second quarter grew 5.2% from a year ago, the second-best performance for the entire expansion. Growth in commercial and industrial loans led the charge, with consumer loans following close behind. This development is constructive and supports expectations of a pickup in economic growth.

- The latest inflation data have moved away from the low readings seen six months ago. The personal consumption expenditure price index rose 1.8% from a year ago in May, reflecting a 0.6% increase from December 2013. The current level is one notch higher than the Fed’s forecast for the end of 2014. The 1.5% year-to-year gain of the core personal consumption expenditure price index represents a 30 basis points gain from December 2013 and matches the Fed’s forecast for 2014.

- We are watching inflation and wage trends closely as further acceleration of both inflation and wages is a sure sign that Fed will step in with measures to normalize rates sooner than current market expectations.**For now, we are affirming our expectation that the Fed will finish tapering in the late fall and begin raising rates late in the summer of 2015.**

- Our outlook for longer-term interest remains a slow upward drift as fundamentals progress and Fed rhetoric begins to prepare investors for less accommodation. There is certainly a risk of a more rapid increase if this communication is not handled well, but the appetite of investors for Treasury bonds has been very strong so far this year. Spreads on corporate bonds will likely remain very narrow, and concern about reaching for yield will remain a part of central bank deliberations.